

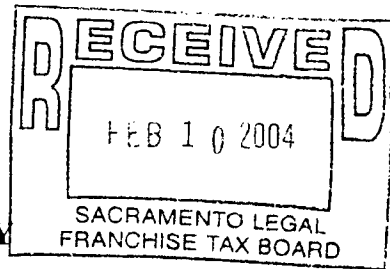
**INFOSYS TECHNOLOGIES LTD
INCOME YEARS ENDED 3/31/01 & 3/31/02
SECTION 25137 PETITION MATERIALS
FEBRUARY 25, 2004**

Tab A – Waiver of Confidentiality

Tab B – Taxpayer's Section 25137 Petition (dated March 28, 2003)

**Tab C – FTB's Staff's Summary and Recommendation (that
Petition be denied)**

EXHIBIT A



WAIVER OF CONFIDENTIALITY

Pursuant to Title 18, California Code of Regulations section 25137(d), petitioner, INFOSYS TECHNOLOGIES LIMITED (California corporate number 1859094) hereby waives the confidentiality provisions of California Revenue & Taxation Code section 19542 with respect to its petition filed under California Revenue & Taxation Code section 25137 and with respect to any other facts and documents which are considered by the Franchise Tax Board in making the determination requested in said petition.

A handwritten signature in black ink, appearing to read "LORIN ENGQUIST", written over a horizontal line.

LORIN ENGQUIST

Name

SENIOR MANAGER

Title

2-4-04

Date

EXHIBIT B

REC'D MAR 28 2003 SJFTB

March 26, 2003

Via Certified Mail

Mr. Melesse Moges
Franchise Tax Board
96 N. Third Street, 4th Floor
San Jose, California 95112-7702

Infosys Technologies LTD
CCN: 1859094

Income Years Ended 3/31/01 & 3/31/02

Petition For Relief Pursuant to California Revenue & Taxation Code §25137

Dear Mr. Moges:

We are in receipt of your information document request to the above referenced taxpayer, whom we represent, dated December 17, 2002. We write to you now in response to your request that the taxpayer present a petition pursuant to the provisions of California Revenue & Taxation Code ("CRTC") §25137 for the two above-referenced years, and accordingly ask that you accept this letter as the taxpayer's petition for an equitable adjustment of standard allocation or apportionment, as provided by that section for the income years ended March 31, 2001 and March 31, 2002.

Statement of Jurisdiction

CRTC §25137 provides as follows:

"If the allocation and apportionment provisions of this act do not fairly represent the extent of a taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- a) Separate accounting;*
- b) The exclusion of any one or more of the factors;*
- c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or*
- d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."*

Accordingly the taxpayer is statutorily authorized to petition the Franchise Tax Board to allow it to use separate accounting to determine the extent of taxpayer's business activity in this state, and the associated Franchise Tax liability for the income years ended March 31, 2001 and March 31, 2002, and hereby does so petition.

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Petition Pursuant to Cal. Rev. & Tax Code §25137

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Statement of Facts

Infosys Technologies Limited was incorporated in 1981 pursuant to the Indian Companies Act of 1956. The company is headquartered in Bangalore, India, and has offices in Europe, Latin America, Australia, South-East Asia, Japan, and the United States, including one in Fremont, California.

The company provides information technology consulting services, and delivers consulting services to its customers through the use of a “Global Delivery Model,” described below.

For the income year ended March 31, 2001, the taxpayer timely filed its California Franchise Tax return. On such return, the taxpayer calculated net income using a modified separate accounting method, and disclosed this fact in a statement attached to the return.

For the income year ended March 31, 2002, the taxpayer again timely filed its California Franchise Tax return. On such return, the taxpayer calculated net income using separate accounting, and attached the associated calculation of net income attributable to California to the return.

The taxpayer petitions hereby to use separate accounting to determine the extent of its business activity in California, and the related Franchise Tax liability for the income years ended March 31, 2001 and March 31, 2002, and for future years until such time as there is a substantive change in facts or circumstances that would make separate accounting inappropriate. This will entail the taxpayer filing an amended return for the income year ended March 31, 2001. On the initially filed return, the taxpayer determined its income using a modified separate accounting method. The taxpayer now petitions to use separate accounting for both of the income years at issue.

Discussion

According to the administrative regulations associated with CRTC §25137, the section may be invoked, and alternative procedures for the determination of income for state purposes may be used, where “unusual fact situations ... produce incongruous results” if the standard apportionment formula is used (Cal. Reg. §25137(a)).

The California State Board of Equalization, in *Appeal of New York Football Giants, Inc.*¹ stated that the standard apportionment procedures might be set aside under CRTC §25137 “where those procedures do not fairly represent the extent of the taxpayer’s activity in this state.” In *Appeal*

¹ Cal. St. Bd. Of Equal., February 3, 1977

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of *Merrill, Lynch, Pierce, Fenner & Smith, Inc.*² the State Board of Equalization further stated that the “*fairness of the reflection of business activity by the formula as a whole which is determinative for purposes of §25137.*”

All court cases and State Board of Equalization appeals which have dealt with distortion, whether the basis of the claim is constitutional³, or statutory⁴, have customarily contained two elements:

- a) A factual analysis, whereby it is demonstrated that the proposed alternative apportionment formula more properly represents the level of the taxpayer's business activities in the state than does the standard apportionment formula.
- b) An empirical analysis of the level of distortion involved in the case, whereby the variance between the standard apportionment formula and the proposed alternative method is demonstrated to be of a significant size, such that departure from the standard apportionment formula is justified in the case.

Accordingly, the taxpayer presents both elements as follows:

A. Factual Analysis of the Taxpayer's Business

The unique structure and nature of the taxpayer's business and the methods employed by the taxpayer in delivering service to its clients when, subjected to the standard apportionment methodologies, causes a much greater California tax burden than is justified by the realities of the taxpayer's activities in this state.

The taxpayer is a software development and consulting firm; it provides software development and maintenance services to a wide variety of companies around the world.

The company delivers service to its customers through a Global Delivery Model. It is the cost and revenue structure inherent to the Global Delivery Model that forms the factual basis of the taxpayer's assertion that the standard apportionment methodology is grossly distortive when applied to its business.

The Global Delivery Model involves small teams of in-country engineers teamed with much larger “off-shore development centers.” When a contract is entered into with a client, a small team of engineers will arrive at the client's site in the United States. They will conduct fact-

² Cal. St. Bd. Of Equal., June 2, 1989

³ See e.g. *Hans Rees' Sons, Incorporated, v. North Carolina Ex Rel. Maxwell* (283 U.S. 123; 51 S. Ct. 385)

⁴ See e.g. *Merrill Lynch, supra.*

finding regarding the needs of the client, then communicate the results to the much larger team of engineers located at an off-shore development center.

The engineers sited at the client's workplace will coordinate the work on the project at a very high level and liaise with the client as needed. But substantially all work on the project actually happens at an offshore development center. When development is complete, the taxpayer deploys an augmented team of engineers to the client's workplace for a short time to facilitate installation and implementation of the software solution.

The Global Delivery Model allows the taxpayer to take advantage of time-zone differences to produce software significantly faster than would otherwise be possible. The vast majority of the offshore development centers are located in various cities in India. The time zone difference between India and the United States and most of Europe is such that, while client personnel are sleeping in the United States, the taxpayer's engineers are working on the project in India. The presence of small teams of engineers at the client site allows the client and the taxpayer's personnel to constantly monitor the progress of the project, and allows for adjustments of the specifications and timing while the project is ongoing.

The taxpayer has other off-shore development centers located in areas such that, if necessary, the taxpayer is able to have engineers working on a development project up to 24 hours a day. In fact, this is not an infrequent occurrence in the taxpayer's business.

The taxpayer estimates that the effort involved in development projects is split between on-site engineers and offshore development centers as follows:

	1997	1998	1999	2000	2001	2002
On-site	19.7%	22.6%	25.0%	32.5%	34.0%	34.0%
Off-shore	80.3%	77.4%	75.0%	67.5%	66.0%	66.0%

It is obvious from the forgoing description that the vast majority of the effort involved in all commercial undertakings at Infosys takes place at offshore development centers outside of the United States. The vast majority of the taxpayer's employees are, as might be expected, located offshore, primarily in India, which has a large pool of skilled information technologists.

The wage structure inherent in the Global Delivery Model, when combined with the differing levels of relative effort illustrated above, are the cause of the gross distortion involved in this case. The taxpayer has significantly lower per capita costs for employees in its offshore development centers when compared to employees within the United States. This can be shown by the following data (figures shown are computed from the year ended March 31, 2002):

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 Petition Pursuant to Cal. Rev. & Tax Code §25137

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	On-site	Off-shore
Per Capita Revenue	137,400	59,100
Per Capita Cost	72,924	7,992
Cost of Services %	53.07%	13.52%
Gross Profit %	46.93%	86.48%

These figures show that the taxpayer can employ more than nine employees offshore for less than it costs it to employ one person within the United States.

$$\frac{72,924}{7,992} = 9.124$$

The large differential in compensation costs between the relatively small number of United States based personnel, and the large number of off-shore personnel, leads to gross distortion in the payroll factor alone. Although a large proportion of the taxpayer's gross payroll costs are paid to employees within the United States, the vast majority of the taxpayer's employees, in terms of headcount, are located off-shore, and the vast majority of the development work, approximately 66% in the years at issue, occurs off-shore.

The skewed California tax that results from this cost differential might be defensible if the work taking place in the off-shore development centers was of an unskilled or semi-skilled variety, but that is not the case here. The offshore employees are at least as skilled, and in many cases more so, as the employees based in the United States. Indeed the vast majority of the more technical and highly skilled work in the taxpayer's case happens at the off-shore development centers, since a large proportion of the work undertaken at the client site is less technical and revolves around definition of technical specifications, communication and coordination. Nearly all technical software development takes place offshore.

The standard payroll factor acts in a distortive way, since it disproportionately weights employee effort involved in the conduct of the taxpayer's business towards the United States. Although the per capita revenue for activities within the United States is higher than offshore activities, the profitability of the activities in the United States is still much lower than that of the offshore activities. The gross margin percentage for onsite activities is 46.93%, whereas the gross margin percentage for offsite activities is 86.48%. Thus any measure of employee effort that is denominated in terms of compensation will tend to grossly distort the amount of the taxpayer's business that is properly attributable to activities in California.

The payroll distortion in the instant case is concentrated in California since the taxpayer's Fremont, California office houses some employees who provide services to support the taxpayer's business throughout the United States, and might deal only incidentally with the

taxpayer's business in California. This tends to concentrate payrolls in the State of California when, in fact, the employees business activities may only incidentally relate to California.

Similar distortion occurs with the property factor, since the cost of the Fremont property is many times more expensive per square foot than the cost of the properties occupied by the taxpayer overseas. Thus, in monetary terms, it may seem that a significant part of the taxpayer's property is located in California. If considered in terms of square footage and the contribution and use of the property towards the taxpayer's net profit, it is clear that a much larger percentage of the taxpayer's property is properly allocable outside of California than would be using the standard property factor.

The standard sales factor also distorts the amount of the taxpayer's net income properly taxable in California. The taxpayer charges generally higher prices for services rendered in the United States than elsewhere. This is to offset the higher costs incurred by the taxpayer. Despite the comparatively higher per capita revenue at gross, the taxpayer's gross margin is much smaller in California than elsewhere. For every dollar of California sales, the taxpayer generates much less gross profit than it does for sales generated outside the state, because the costs of performing the California activities are higher. Thus, any measure of sales at gross will tend to improperly attribute profit to California which was in point of fact attributable elsewhere.

The standard apportionment formula is based on an assumption that a taxpayer's net profit is a product of its property, payroll, and sales. But in this case, as shown above, the taxpayer's California property, payroll and sales generate much less profit than do the taxpayer's property, payroll, and sales outside of California. Stated differently, because of its business model, the taxpayer's activities within California generate far less profit than do its activities out of California, but that reality is not properly reflected in nor captured by the standard apportionment formula. The standard formula overstates the profit from the taxpayer's California activities. As such, the taxpayer seeks to use separate accounting to determine the extent of the taxpayer's business in this state. The separate offsetting of income and expense from its business in this state is the only proper way to determine the tax liability which should equitably result from its business activities in this state.

The separate offsetting of income and expense allocable to the taxpayer's business in this state will eliminate the effect of the difference in relevant cost structures, and more properly represent the California net income.

For the income year ended March 31, 2001, if the taxpayer were to determine the extent of its business activity in California according to separate accounting, the taxpayer would have California taxable loss of (\$729,710). For the related calculations for the income year ended March 31, 2001, see Exhibit A.

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For the income year ended March 31, 2002, the taxpayer originally filed this return using separate accounting. The method advocated by the taxpayer resulted in California taxable income of \$4,074,805. details of the calculation were included as an attachment to the originally filed return.

B. Empirical Analysis of Distortion

An empirical analysis of the distortion is presented to demonstrate that the distortion rises to a level sufficient to require deviation from the standard apportionment formula.

In *Hans Rees' Sons, Inc. v. North Carolina Ex Rel. Maxwell*⁵, the standard apportionment rule used in North Carolina resulted in an average North Carolina apportionment factor of eighty percent (80%). The trial court determined, however, that the taxpayer's income attributable to North Carolina, according to separate accounting principals, did not exceed 21.7% of its total income. In order to arrive at the over 250% change attributable to the different methods that was cited by the Supreme Court of the United States in its opinion, note the following calculation:

$$\frac{(80\% - 21.7\%)}{21.7\%} = 269\%$$

The above formula represents the following:

$$\frac{(\text{Standard apportionment} - \text{Alternative Apportionment})}{\text{Alternative Apportionment}} = X$$

This formula has been consistently applied by the courts when conducting empirical analysis of the level of distortion in apportionment cases. For example, the same formula was applied by the California courts later in *Colgate-Palmolive Company, Inc. v. Franchise Tax Board*⁶. In *Colgate*, the standard apportionment formula produced California taxable income of \$4,783,746 while the special formula produced \$2,777,661. The Court held that the standard apportionment formula increased the taxpayer's California taxable income from the special formula by approximately 70% (which was held not to be sufficiently distortive). Note that the following computation was used:

⁵ (1931) 283 U.S. 123; 51 S.Ct. 385.

⁶ 10 Cal. App. 4th 1768

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$$\frac{(\text{Standard Apportionment Taxable Income} - \text{Special Apportionment Taxable Income})}{\text{Special Apportionment Taxable Income}} = X$$

$$\frac{(\$4,783,746 - \$2,777,661)}{\$2,777,661} = 72\%$$

The same test is customarily applied by California's State Board of Equalization to judge distortion cases brought before it. When multiple tax years are involved, these tests have generally been applied on an average basis across such years, and accordingly the taxpayer will do the same in this case.

The taxpayer petitions for permission to use an alternative method for the determination of income for state purposes, since the distortion caused by application of the standard apportionment formula rises to a level significantly higher than that of cases where the courts have denied relief, and in fact at about the same level as *Hans Rees*, where the Court granted relief.

In the taxpayer's case, the standard apportionment formula would have led to California taxable income of \$13,657,635 in income year ended March 31, 2001 and \$15,147,365 in income year ended March 31, 2002. Thus, using the standard method, the average California taxable income across the years at issue is \$14,402,500, and the average tax liability would be 1,273,181.

The alternative method proposed by the taxpayer in the subject years results in a taxable loss of \$(729,710) (and thus a tax of \$800) in income year ended March 31, 2001, and taxable income of \$4,074,805 (and tax of \$360,213) in income year ended March 31, 2002. Thus, under separate accounting, the average California taxable income across the years at issue was \$1,672,548, and average California tax liability would have been \$180,507.⁷

These numbers (using taxable income) produce the following distortion percentage:

$$\frac{(\text{Standard Apportionment Taxable Income} - \text{Special Apportionment Taxable Income})}{\text{Special Apportionment Taxable Income}} = X$$

$$\frac{(\$14,402,500 - \$1,672,548)}{\$1,672,548} = 761\%$$

⁷ The taxpayer is statutorily prohibited from using the loss carryover from income year ended March 31, 2001 to offset taxable income in the income year ended March 31, 2002.

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These numbers (using tax liability) produce the following distortion percentage:

$$\frac{(\text{Standard Apportionment Tax} - \text{Special Apportionment Tax})}{\text{Special Apportionment Tax}} = X$$

$$\frac{(\$1,273,181 - \$180,507)}{\$180,507} = 605\%$$

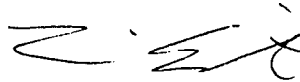
In *Colgate-Palmolive*, supra, the California Court of Appeals for the third appellate district denied relief from the standard apportionment formula, where the empirical level of distortion reached an average of 72% over the income years at issue. The empirical level of distortion in this case is significantly higher than that seen by the California appellate courts in *Colgate*.

In *Hans Rees*, supra, the Supreme Court of the United States granted relief on constitutional grounds when empirical distortion reached an average of 269% over the income years at issue. North Carolina did not have a statutory alternative to its standard apportionment formula at the time the Supreme Court heard *Hans Rees*, and so the relief was granted on federal constitutional grounds.

Conclusion

For the reasons set forth above, and in the interests of equity, the taxpayer should be granted relief from the standard apportionment formula outlined in CRTC §25128 et seq., and permitted to use the alternative apportionment methods advanced by the taxpayer, as authorized by the provisions of CRTC §25137. Although separate accounting is the method which will most fairly represent the extent of the taxpayer's business activity in this state, the taxpayer is also prepared to discuss the use of other alternate methods that the FTB may wish to propose which best reflects the business model of the taxpayer.

Respectfully Submitted,



Lorin Engquist, Esq.
Senior Manager
Ernst & Young LLP
Authorized Representative of
Infosys Technologies Limited

Exhibits

Computation of the taxable income for the State of California under the separate accounting method
for the year ended March 31, 2001

Income from services	37,417,892
Interest	321,854
Total Revenue	37,739,746
Cost	
Manpower Cost	24,322,012
Travel cost	1,819,024
Legal & professional	42,517
Rates & taxes	58,114
Bad Debts written off	682,340
Discount & Commission	54,133
Branch costs	837,072
Stock Compensation credit	227,473
Total direct cost	28,042,685
Allocation of direct US expenses	
Allocation of US overhead salaries	238,809
Legal & professional	235,139
Data Communication expenses	533,254
Gross Margin	8,689,858
Allocation of Overhead expenses	8,719,055
Allocation of depreciation	700,514
Net Profit/(Loss)	(729,710)

California Form 100, Page 1 Detail

California State Separate Accounting

Total Revenues	54,670,108
Direct Expenses	
Wage cost	31,871,122
Travel cost	3,986,490
Legal & Professional	235,398
Insurance	1,224,886
Bad Debts written off	199,509
Rates & Taxes	18,812
Rent	527,110
Office Maintenance	212,432
Branch expenses	1,450,762
Discounts & Commision	101,098
Total Direct Cost	39,827,618
Gross Margin	14,842,490
Stock Compensation Credit	625,770
Overhead Cost	8,581,959
Depreciation - Direct	680,129
Depreciation - Overhead	877,804
Loss on FA Disposal	2,023
TOTAL	10,767,685
California Net Income, Form 100, line 18	4,074,805

EXHIBIT C

STAFF RECOMMENDATION SECTION 25137 PETITION INFOSYS TECHNOLOGY LTD.

STATUS

The taxpayer's fiscal years ended 03/00 through 03/02 are currently being audited. The taxpayer used three different ways of filing its return for the three years under audit.

For FYE 03/00 the taxpayer filed a worldwide combined report and apportioned its income to California using the standard allocation and apportionment rules set forth under sections 25120-25136.

For FYE 03/01 the taxpayer first calculated its income that was "effectively connected" with the conduct of a trade or business in the United States and then, apportioned this income to California based on the standard apportionment formula principles based on United States activities only. This apportioned income was then further reduced by "Direct Cost-Specific to California."

For FYE 03/02 the taxpayer calculated its California income using a form of "separate accounting."

As part of the audit it has filed a petition requesting that for the FTE 03/01 and 03/02 that it be allowed to use its form of "separate accounting" to determine the amount of income attributable to California.

STAFF RECOMMENDATION

Staff recommends that the taxpayer's petition be denied.

BACKGROUND

Infosys Technology Ltd, founded in 1981, is an IT consulting and service company based in India that utilizes an extensive non-U.S.-based infrastructure to provide managed software solutions to clients worldwide. The company's services include custom software development, maintenance and re-engineering services, e-commerce and internet consulting, as well as offshore software development centers for certain clients. The taxpayer is headquartered in Bangalore, India, and has sixteen state-of-the-art offshore software development facilities located throughout India and one global development center in Canada to provide managed software solutions to clients worldwide. The company has also set up Proximity Development Centers (PDCs) at Croydon in the UK, New Jersey, Boston, Chicago, Phoenix and Fremont, California, in

the United States. The company's worldwide sales headquarters is located in Fremont, California. The company has 28 sales offices (8 in other U.S. states) located in 15 countries at the end of 2002. The Fremont office, besides its sales operation, also has Human Resources, VISA, Finance, Marketing, IT and IS departments that provide support functions to the other U.S. sales offices.

The company's revenues are generated principally from software services provided on a fixed-price, fixed time frame, or a time-and-material basis. From fiscal 2000 through fiscal 2002, total revenue increased from \$203.4 million to \$545.1 million. The increase in revenues was attributable to an increase in the number of projects executed and also due to a steady increase in business from existing and new clients.

The company describes its business as follows:

The company delivers service to its customers through a Global Delivery Model. This model involves small teams of in-country engineers teamed with much larger "off-shore development centers." When a contract is entered into with a client, a small team of engineers will arrive at the client's site in the United States. They will conduct fact finding regarding the needs of the client, then communicate the results to the much larger team of engineers located at an offshore development center.

The engineers sited at the client's workplace will coordinate the work on the project at a very high level and liaise with the client as needed. But substantially all work on the project actually happens at an offshore development center. When development is complete, the taxpayer deploys an augmented team of engineers to the client's workplace for a short time to facilitate installation and implementation of the software solutions.

The company derived 75% of its total revenues from North America, 15% from Europe, 2% from India and 8% from the rest of the world from diversified clients. Approximately 66% of the work on project was performed in India. The total number of employees at the end of 2002 was 10,738.

ARGUMENTS IN SUPPORT OF PETITION

The taxpayer makes two analyses; first, what it terms a "factual analysis" and, second, an "empirical analysis."

Factually it argues that its off-site activities related to its contracts are significantly greater than its on-site activities. It points out that each of the three factors distorts in favor of California because labor and property costs are higher in California, and there is less profit associated with California sales.

Empirically, the taxpayer argues, using only the FYE 03/01 and 03/02 results, California's apportioned share of worldwide income is many times its separate accounting income attributable to California. Because the percentage exceeds that found to be unconstitutional in *Hans Rees' Sons, Inc. v. North Carolina* (1931) 283 U.S. 123, the taxpayer claims that it is entitled to relief.

The taxpayer's request and arguments are attached.

STAFF RESPONSE

The taxpayer's arguments are similar to those made by many other taxpayers and rejected by the courts and the State Board of Equalization.

The factual argument, fully developed, was presented to the California courts in the case of *John Deere Company of Moline. v. Franchise Tax Board* (1951) 38 Cal.2d 214. In that case the taxpayer argued on the basis of separate accounting data that each of the three factor values in California was less productive of income than were the same factors out of California. The arguments were rejected by the court based upon the following reasoning:

But in so arguing, plaintiff fails to take into account the underlying concept of formula apportionment in the allocation of income from a unitary business: that the unitary income is derived from the functioning of the business as a whole, to which the activities in the various states contribute; and that by reason of such interrelated activities in the integrated overall enterprise, the business done within the state is not truly separate and distinct from the business done without the state so as reasonably to permit a segregation of income under the separate accounting method rather than use of the formula method in assigning to the taxing state its fair share of taxable values. *Id.*, at 233.

Similar arguments were also rejected by the United States Supreme Court in *Container Corporation of America v. Franchise Tax Board* (1983) 463 U.S. 159 under an identical analysis. Taxpayers' efforts to use a comparison of the relative productivity of property, payroll and sales in California to other jurisdictions to impeach a formula result have been rejected for over five decades. Staff believes that the Board should continue to reject these arguments under the same reasoning.

The taxpayer's empirical argument is also based upon separate accounting results. Attempts to impeach or show the unreasonableness of the formula result by reference to separate accounting results has been consistently rejected by the Courts and the Board of Equalization. See, e.g., *Butler Bros. v. McColgan* (1941) 315 U.S. 501; *Container, supra*, and *Appeal of Crisa Corporation*, Cal. St. Bd. of Equal., June 20, 2002.

In addition, percentage comparisons of results achieved under different methods is suspect. For example in the present case, if only the FYE 03/01 is examined, the percentage change between a separate accounting loss and an apportioned profit is infinite. This numerical comparison has been presented unsuccessfully in a number of court cases. See, e.g., *Butler Bros. v. McColgan* (1941) *supra*; *Edison California Stores, Inc. v. McColgan* (1947) 30 Cal.2D 471; *Mobil Oil Corp v. Vermont* (1980) 445 U.S. 425; and *Exxon v. Wisconsin Dept. of Rev.* (1980) 447 U.S. 207.

As the Board of Equalization said in *Appeal of Crisa Corporation, supra*:

Unfortunately, a discussion of percentage comparisons in distortion cases is often wrongly interpreted as having greater significance than it actually has and acts as a distraction from the primary task of determining whether the standard apportionment formula fairly represents the extent of the taxpayer's business activity in California.

The taxpayer was engaged in a unitary business. Under California case law, *Honolulu Oil Corp. v. Franchise Tax Board* (1963) 60 Cal.2d 417 and *Superior Oil Co. v. Franchise Tax Board* (1963) 60 Cal.2d 406, a unitary business must file under the unitary method. The unitary business realized a profit for each of the years at issue. There is nothing unfair about attributing a portion of those profits to California.

The taxpayer's request to use separate accounting should be rejected. Staff would also note that the taxpayer had the option of separately incorporating its United States activities and making a water's-edge election. Making a water's-edge election would have allowed it to account for its United States activities separately, subject of course to an arm's-length examination. It chose not to do so. It should not be permitted to achieve indirectly what the legislature gave it the opportunity to do directly.



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February 11, 2004

Mr. Benjamin F. Miller
Franchise Tax Board – Legal Branch
P.O. Box 1720
Rancho Cordova, CA 95741-1720

Infosys Technologies Ltd.
Petition Pursuant to California Revenue & Taxation Code §25137

Dear Mr. Miller:

We are writing to you pursuant to your January 27, 2004 letter to us and in response to the FTB staff recommendation with respect to the above referenced petition, a copy of which was included in your letter to us. The following is the taxpayer's response to the FTB staff recommendation; we respectfully request that it be forwarded to the Board.

I. Nearly All of the Cases Cited by the Franchise Tax Board Staff are Inapplicable.

The majority of the cases cited by the FTB staff involved challenges to formulary apportionment based on the Due Process and Equal Protection clauses of the federal constitution. The instant petition is not a constitutional challenge to formulary apportionment, but is rather a petition for equitable relief grounded in a specific statutory grant of authority found in California Revenue & Taxation Code §25137.¹

Staff points to John Deere Plow Company of Moline v. Franchise Tax Board² as being dispositive of the taxpayer's factual analysis in this petition. We disagree. Initially we note that the California Supreme Court handed down its opinion in John Deere in 1951. Section 25137 was enacted in 1966, so the statute that forms the basis of this petition did not even exist when the California Supreme Court opined in John Deere. Indeed, the taxpayer's claim in John Deere was constitutional in nature (grounded in the Equal Protection and Due Process clauses) rather than statutory. **The petition here being considered by your Board raises no constitutional challenge to formulary apportionment, but rather seeks equitable relief from your Board as specifically authorized by §25137.**

Staff likewise cites Container Corporation of America v. Franchise Tax Board.³ Like John Deere, Container Corporation involved a federal constitutional challenge to California's formulary apportionment regime grounded in the Due Process and Commerce clauses. The taxpayer's claim in Container Corporation was not based on a §25137 petition.

¹ All statutory references herein refer to the California Revenue & Taxation Code, unless otherwise provided.

² 38 Cal. 2d 214

³ 463 U.S. 159



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Most of the other cases cited by staff may similarly be classified as being of limited usefulness, since they deal with purely constitutional challenges to formulary apportionment and/or were decided prior to the enactment of §25137.

The only case cited by staff that considers the application of §25137 is Appeal of Crisa Corporation⁴, which we discuss below.

II. Staff Mischaracterized the Analysis Presented by the Taxpayer in Support of this Petition.

Staff mischaracterized the arguments presented by the taxpayer's petition. The taxpayer presented both factual and empirical arguments in support of its petition to your Board. Staff characterized these two elements as separate, autonomous analyses, each intending to stand on its own. But neither is meant to stand alone; they are instead complementary, as the party wishing to depart from the standard apportionment formula must show that an alternative measure both produces a sufficiently different result and more fairly represents the extent of the taxpayer's business activity in California.

In Crisa Corporation⁵ the Board of Equalization stated:

The central question under section 25137 is not whether some quantitative comparison has produced a large-enough "distortive" figure. Rather, the question is whether there is an unusual fact situation that leads to an unfair reflection of business activity under the standard apportionment formula... The answer to this question lies in an analysis of the relationship between the structure and function of the standard apportionment formula and the circumstances of a particular taxpayer. If the analysis reveals some manner in which the standard formula does not adequately deal with the taxpayer's circumstances, then section 25137 may apply.

Clearly, in the opinion of the Board of Equalization, the central issue in distortion cases is whether the structure of the standard apportionment formula adequately deals with the circumstances of the individual taxpayer. Such a determination is necessarily based on the facts of every case. The fact that the Board of Equalization did not find distortion in Crisa Corporation's case does not mean that distortion does not exist in Infosys's case. The determination can only be made after an examination of the taxpayer's business model and how it is captured by the standard apportionment formula. This is precisely what Infosys did in the "factual analysis" section of its petition.

⁴ Cal. St. Bd. Of Equal. June 20, 2002.

⁵ Ibid.



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The taxpayer's petition showed that the standard payroll factor was not at all representative of the extent of its business in this state due to a combination of factors, most notably the taxpayer's unique business model and the sharp wage differentials between the United States and the various jurisdictions in which the vast majority of the productive work undertaken by the taxpayer's business occurs.

Similarly, the petition explained that the standard sales factor was not representative of the extent of the taxpayer's business in this state. In the case of the sales factor, sharp market price differentials for custom software products combined with the taxpayer's unique business model to greatly exaggerate the taxpayer's California sales factor when compared to the true extent of the taxpayer's business activity in this state.

Thus the factual narrative illustrated how the standard apportionment formula failed to adequately deal with the factual circumstances of the taxpayer's business. This factual narrative was necessarily complemented by empirical information because the standard formula may only be replaced when it is sufficiently distortive. As such, questions concerning formulary apportionment and distortion necessarily can only be answered with arithmetic.

It was never the taxpayer's intention for these two different approaches to be viewed separately. Nor was it the taxpayer's position that an empirical analysis alone should be determinative of this petition. Rather, as the Board of Equalization made clear in Crisa Corporation, the case turns on the factual circumstances of the taxpayer.

III. Conclusion

The discussion included with the original petition to your Board clearly demonstrates that the standard apportionment formula does not adequately reflect the extent of the taxpayer's business in this state.

For the reasons set forth above and in the taxpayer's original petition to your Board, the taxpayer respectfully requests that your Board grant the taxpayer relief from the standard apportionment formula contained in §25128 et seq.

Respectfully Submitted,

A handwritten signature in black ink, appearing to read 'L. Engquist', written over a horizontal line.

Lorin Engquist, Esq.
Authorized Representative of
Infosys Technologies Limited